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ISSUES FOR DISCUSSON:

OTHER NON-FINANSIAL ASSETS AND RELATED MATTERS

National Organization for Financial Accounting and Reporting Standards
Russia

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Introduction

Existing Standards and Interpretations set out accounting models for main types of assets and liabilities. Meanwhile some specific items remain out of scope, and require appropriate accounting approach to be determined.

We would like to discuss issues related to accounting of other non-financial assets, to share our views on relevant accounting approaches, to review current best practice and to formulate preliminary recommendations for further consideration by IASB.

In this paper we consider the most common situation based on our experience in Russia and believe that the raised questions are also important for other emerging economies.

As an emerging market Russian economy demonstrates specific signs common for the other developing countries.

In order to obtain financing and continue normal performance many companies set forth prepayment requirements thus compensating the lack of financing for their activities. That is typical for Russian companies with long-term performance obligations settled in contracts for 10-20 years, such as sales of oil and gas.

Currently, paid advances (advance payments given) and advances received are not regulated by IFRS as a separate item with settled recognition and measurement criteria. Those items are treated neither as financial assets/liabilities nor as specific non-financial items.

Additionally we would like to discuss a specific issue and proposed accounting approach related to the problem of interest capitalization in case the loan changes its characteristics.

1. Paid advances (advance payments given)

1.1. Classification and presentation of paid advances

In normal course of business the future economic benefit of paid advances is the receipt of goods or services, rather than the right to receive cash or another financial asset. Therefore the paid advances are not financial assets (AG 11, IAS 39).

Economic nature of the paid advances is the earlier stage of acquisition of goods or services, irrespectively of whether the paid advances are refundable or not.

The IFRSs set out different accounting models for different assets and liabilities depending on how they will affect the future inflows of outflows of economic benefits. Therefore that the paid advances should be accounted for in the same way as the goods or services for which they are given.

Thus we suppose that the paid advances should be classified at the recognition date as the corresponding goods or services for which they are given. And they should be represented as components of the corresponding groups of assets within the Statement of financial position (with subsequent disclosure in the notes).

Examples of the proposed approach could be the following.

- Paid advances for inventories should be classified as inventories. Because based on their destination they meet the definition of inventories – as assets: (a) held for sale in the ordinary course of business; (b) in the process of production for such sale; or (c) in the form of materials or supplies to be consumed in the production process or in the rendering of services.
- Paid advances for property plant and equipment (PPE) should be classified as PPE (or assets under construction). Because based on their destination they meet the definition of PPE – as tangible items that: (a) are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and (b) are expected to be used during more than one period.

Paid advances for services could be also classified as separate item and could be represented in the Statement of financial position either as a separate item or aggregated with other items (with subsequent disclosure in the notes).

1.2. Measurement of paid advances

Following the above mentioned approach we suppose that the paid advances should be measured using the same model as the corresponding goods or services for which they are given.

For example, paid advances for inventories should be measured at the lower of cost and net realisable value of the corresponding inventories for which they are paid.

Alternatively, the paid advances could be measured at their historical cost (amount of paid consideration).

Additionally the following matters should be considered:

- adjustment for a contractor's credit risk,
- adjustment for a significant finance component,

- foreign currency adjustments,
- measurement of non-cash consideration,
- relevance of revaluation model,
- use of percentage-of-completion method.

1.3. Contractor's credit risk

Paid advances have dual economic nature:

- from one side, they represent earlier stage of acquisition of goods or services,
- from other side, they represent the right to receive goods or services.

The inflow of future economic benefit on the paid advances will significantly depend on the contractor's ability to supply the corresponding goods or services.

Therefore we suppose that additionally to use of accounting model applicable to corresponding goods or services, the book value of paid advances should be adjusted in order to reflect a contractor's credit risk.

An entity should apply appropriate accounting policy in order to measure and reflect correctly a contractor's credit risk. The measure of a contractor's credit risk should be revised at each reporting date.

1.4. Significant financing component within paid advances.

As mentioned above the paid advances are often used in emerging economies as a mean of financing of operating and even investment activities of the contractor.

We suppose, that if the paid advances include significant financing component, their book value should be adjusted for the effects of the time value of money.

A significant financing component exists if the actual timing of payments provides the contractor with a significant benefit of financing (similarly to the requirement of IFRS 15, p. 60).

The adjusted value of the paid advances could be calculated as present value of consideration paid if it would be paid at the time (in future) of goods/services delivery.

An entity shall present the effects of financing (interest revenue) separately in the statement of comprehensive income with corresponding increase the book value of paid advances.

Finally to the time of goods/services delivery the book value of paid advances will be equal to their nominal (contractual) value. And the cost of purchased goods or services will be determined as if the financing component would not exist.

At the same time, we accept that this approach could be not easy to apply (because of possible uncertainty of timing of goods/services delivery) and should be further elaborated in all respects.

1.5. Foreign currency translation adjustments

When the paid advances are nominated in foreign currency, they have to be restated in functional currency in accordance with IAS 21.

According to the IAS 21, p. 16, the paid advances are non-monetary assets because in normal course of business an entity does not expect to receive a fixed or determinable number of units of currency (irrespectively of whether the paid advances are refundable or not).

Therefore paid advances nominated in foreign currency on initial recognition should be recorded in functional currency using the spot exchange rate at the date of the transaction (payment). Subsequently as each reporting date they should be measured at historical exchange rate (at the date of transaction) without recognition of any exchange differences.

The initial cost of goods or services received in exchange of paid advances nominated in foreign currency should also be measured using the spot exchange rate at the date of advance payment, without any adjustment to the exchange differences.

1.6. Measurement of non-cash consideration

If the paid advances have been arose from a transfer of consideration in a form other than cash, an entity shall measure the non-cash consideration at fair value (similarly to the requirement of IFRS 15, p. 66).

If an entity cannot reasonably estimate the fair value of the non-cash consideration, the entity shall measure the consideration indirectly by reference to the stand-alone selling price of the goods or services to be supplied by the contractor in exchange for the consideration (similarly to the requirement of IFRS 15, p. 67).

1.7. Relevance of revaluation of paid advances

There could be the cases then the paid advances relate to the PPE or other assets accounted for using the revaluation model.

Example. Company “A” purchase a car and makes prepayment in amount of 20% of car price. The car will be delivered in 6 months, which comes to next reporting period. The Company uses revaluation model for the measurement of its PPE. Should the Company revalue the paid advance classified as PPE as of the reporting date?

Customizing the above mentioned approach, we suppose that in this circumstances it will be more relevant not to revaluate such paid advances (as PPE or other assets) until the corresponding assets are not delivered.

1.8. Use of percentage-of-completion method

If the paid advances relate to services that are to be rendered over time, an entity can depreciate the initial value of the paid advances using a systematic basis that reflects the time pattern of transfer (consumption) of the benefits from the services.

We accept that more sophisticated approach could be elaborated to better reflect the transfer (consumption) of benefits from services in cases when the control over the work results is transferred over time (similarly to percentage-of-completion -methods provided in IFRS 15).

2. Paid letter of credit

2.1. Simple letter of credit

Letters of credit are used primarily in international trade, including emerging economies.

A letter of credit is an agreement under which an issuer (a bank or similar financial institution) assures payment to a seller of goods or services provided certain documents have been presented to the issuer. The letter of credit serves as a guarantee of payment to the seller regardless of whether the buyer fails to pay. It is also ensure that all agreed conditions are met by the supplier.

In such understanding the letter of credit is regarded as financial guarantee or credit insurance and its accounting by the issuer is within the scope of IAS 39, IFRS 9 or IFRS 4.

2.2. Paid letter of credit

In Russia as an emerging economy it is often used a scheme called “a paid letter of credit”, when a bank (the issuer) asks an entity (the buyer) to make deposit to the amount equal to the nominal of the letter of credit. In this case the bank does not bear the risk anymore and act only as service-agent. The whole amount of goods and services to be purchased is fully financed by deposit to the bank.

We suppose that in such cases the paid letters of credit should be classified as paid advances and should be presented and measured correspondently (as discussed above).

2.3. Paid letter of credit financed by a loan

It is also common a situation when a paid letter of credit is financed by the loan of the same bank (the issuer), and the whole deal is performed in complex:

- the bank issue a credit letter to the seller (as a guarantee of payment of the buyer),
- the bank gives a loan (short-term or long-term) to the buyer to the nominal of the letter of credit,
- the buyer make a deposit to the bank in the nominal of the letter of credit (thus letter of credit become paid).

Some commentators recommend that in this case the buyer should offset the loan received from the bank and the deposit made to the same bank. But in our view, the deposit should be treated separately as paid advance (as mentioned above) and the loan should be accounted for separately in accordance with IFRS 9.

3. Other material assets

3.1. Materials of long-term use

Companies often have materials of long-term use – i.e. the materials that are to be used in the production process or in the rendering of services in a long-term period (more than one year or more than one operation cycle) during which they will be fully or partly consumed or after which they will have to be replaced. Examples of such materials could be the catalysts in oil refinery industry.

The definition of Inventories given in IAS 2 includes materials or supplies to be consumed in the production process or in the rendering of services irrespectively of whether it will be during short-term period or long-term period (one or more operating cycles). And this definition does not include assets that to be used in the production process or in the rendering of services and should be replaced after a long-term period.

We suppose that such materials of long-term use should be accounted for under another accounting model – similar to the model set by IAS 16 (i.e. at amortized costs) and should be represented as long-term assets.

3.2. Assets to be transferred in a finance lease

Leasing companies often have in their balances the specially purchased assets that to be transferred in a finance lease. Such kind of assets is not covered by the scope of any Standard or Interpretation. Meanwhile such assets have their specific characteristics of economic benefits and risks as of the reporting date, because they are not yet have been transferred to a lessee.

The existing Standards and Interpretation do not clearly indicate how such assets should be classified.

If an operation of finance lease is considered as equivalent to a sell with subsequent financing, then the assets that are to be transferred in a finance lease should be treated as assets held for sale. Then:

- the assets that are to be transferred in a finance lease as part of ordinary course of business (e.g. for leasing companies, dealers or producers) should be considered as inventories according to the IAS 2;
- the assets that are to be transferred in a finance lease as part decommissioning process (e.g. disposal of assets after use) should be treated as non-current assets held for sale according to the IFRS 5.

Alternatively, for leasing or finance companies the acquisition of assets for subsequent transfer in a finance lease could be seen as an initial part of the investment process. And such asset could be regarded as vehicle to render finance services. In this case such asset should be accounted for as part of the investment portfolio – as part of the net investment in lease (even if it is not yet transferred to a lessee) according to the IAS 17, but only if it relates directly to a contract or to an anticipated contract with a lessee.

3.3. Withdrawn Assets

Some companies can hold assets withdrawn from third parties (“withdrawn assets”). For examples, banks, leasing companies, collection agencies and other companies can hold assets withdrawn from debtors as seizure of collateral.

We suppose that such “withdrawn assets” should be accounted for according to their nature and their purpose in the reporting company (using the corresponding accounting model under IAS 2, IAS 16, IAS 40, IFRS 5 and others).

Meanwhile, if the “withdrawn asset” represent a current material asset that will be sold, but not in the ordinary course of business, then such asset in not within the scope of IAS 2 nor IFRS 5. Nevertheless, we propose to account them for similar to non-current assets held for sale according to the IFRS 5.

3.4. Strategic materials

For some companies there could be specific legislative or license requirements to maintain some irreducible quantity of specific materials (“strategic materials”). Examples of such strategic materials could be: specific fuels, metals of chemicals. These materials often have the following characteristics.

- They are rare and comparatively expensive.
- They could have a limited liquidity, because of absence of open market or other restrictions.
- The variants of use them could be the following:
  - they are not used the ordinary activity,
  - they can be used or sold with profit in course of ordinary activity,
  - they can be used only in specific emergency cases (under commercial conditions),
  - they have to be expensed without any compensation in specific emergency cases.

The accounting of such “strategic materials” in some of the abovementioned circumstances is outside the scope of the IAS 2 “Inventories”.

Only if such “strategic materials” are to be used of sold in the ordinary course of business, they should be accounted for in accordance with IAS 2. Additionally there should be an option to represent these items as long-term assets according to the planed schedule of their usage of sell.

But if such “strategic materials” can be used only in specific emergency cases (with or without compensation), they actually represent the right to run this kind of business and respectively should be accounted for as intangible assets.

3.5. Investment materials

Some companies (especially such as: investment companies, banks and other financial institution) holds physical amount of materials for investment purposes (for sell in long-term perspective, capital appreciation or capital preservation). (“investment materials”). Examples of such items could be: precious metals and stones.

Based on their purposes these materials do not meet the definition of inventories set out in the IAS 2.

We suppose that the “investment materials” should be represented as separate item of shout-term assets and measured at fair value through profit and loss.

4. Refundable VAT and other refundable taxed and contributions

4.1. Recognition, measurement and presentation

In emerging economies companies often have significant balances of refundable or overpaid taxes and contributions (including VAT) that are to be subsequently reimbursed subject to specific criteria.

An entity should recognise as assets refundable or overpaid taxes and contributions (including VAT) only if all of the following criteria a met:

- the entity have a current right to reimburse them (either in form of future cash inflows or in form of offsetting future payments of taxes and contributions),
- it is highly probable that the entity will use this current right in the foreseeable future,
- the amount of refundable or overpaid taxes and contributions that will be reimbursed can be measured reliably.

At recognition an entity should measure the refundable or overpaid taxes and contributions at historical costs. After initial recognition the measurement of these items should reflect the expected amount that can be reimbursed (with possible recognition of impairment loss). If appropriate the amount of impairment loss can be reversed in subsequent periods.

Refundable or overpaid taxes and contributions shall not be discounted.

In the statement of financial position an entity should offset refundable or overpaid taxes and contributions (including VAT) with corresponding amounts of taxes and contributions payable only if, the entity:

- has a legally enforceable right to set off the recognised amounts; and
- intends either to settle them on a net basis, or to reimburse the asset and settle the liability simultaneously.

4.2. Offsetting with accounts payables and other liabilities

In some jurisdictions (including Russia) recognised amounts of refundable VAT are linked with corresponding amounts within accounts payables, advances received and other liabilities.

For example, in Russia according to tax legislation a seller having received an advance payment should pay a VAT that will be refundable after the seller will deliver corresponding goods or services. Thus, the same amount of VAT will be shown as asset “Refundable VAT” and will be included in liabilities as part of “Advances received”.

Some commentators recommend that in such cases these amounts of VAT should be netted to avoid double counting.

But we suppose that such balances of refundable VAT should not be netted with the linked VAT amounts within liabilities, because these items could have different liquidity and could be different in nature (“Refundable VAT” is a monetary item but “Advances received” is a non-monetary item).

5. Capitalization of interest issue

5.1. Case for discussion

The Company carries out an extensive investment program on construction of fixed assets and finance it by bonds issue and long-term borrowings with the maturity of over 10 years. The Company recognizes as a qualifying asset the asset that necessarily takes a period of more than 12 months to get ready for its intended use. The planned construction period of the qualifying assets under the investment program is not more than 3 years.

The Company makes an overall assessment of funding requirements for the implementation of the investment program in a particular period. The received funds are deposited on a special bank account and then are broke down by payments for particular contractors for particular qualifying assets. The decision on allocation of funds among the qualifying assets is made by the Company's management and is not provided for in the prospectus of bonds and loan agreements, but can be stipulated by the Company's policies and procedures, and in this case the funds are considered as special-purpose borrowings.

5.2. Approaches to borrowing costs accounting

When accounting for borrowing costs the Company applies the current accounting legislation. The accounting procedures are identical to that of reporting in accordance with national GAAP and IFRS.

In accordance with national GAAP: "the interest due for payment to the borrower directly attributable to the acquisition, construction and (or) production of a qualifying asset is included in the cost of that asset". The accounting principles establish different procedures for capitalization of borrowing costs directly attributable to the acquisition, construction and (or) production of a qualifying asset and other borrowing costs. At the same time, the principles do not specify clearly the criteria of determining the purpose of borrowings and its classification.

However, in accordance with another national regulation the Company has the right to make assumptions when calculating borrowing costs to be included in the cost of a qualifying asset.

In accordance with national GAAP: "If the legislation do not specify the accounting method on a particular issue the entity shall develop a relevant accounting policy on the basis of that and other accounting regulations as well as the International Financial Reporting Standards".

The Company developed the allocation method for borrowing costs to be included in the cost of a qualifying asset based among others, on IAS 23 "Borrowing Costs".

In accordance with p.10 IAS 23 "Borrowing Costs": "The borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are those borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made".

To determine the amount of capitalized borrowing costs as part of the cost of qualifying assets financed by special-purpose borrowings the Company applies the following approach.

Borrowing costs are allocated in two stages:

- When borrowed funds are transferred to the contractors from the special bank account for the acquisition of a qualifying asset financed by the special-purpose borrowings

the calculation of capitalized borrowing costs is based on the average monthly interest rate of such borrowings.

- Then, the weighted average interest rate is determined for allocation of borrowing costs of funds obtained for general purpose, excluding qualifying assets financed by special-purpose borrowings. This rate it used for allocation of borrowing costs to the cost of qualifying assets financed by both special-purpose and general purpose borrowings.

When the acquisition, construction or production of qualifying assets financed by special-purpose borrowings is complete the allocation method is changed.

Remaining part of the borrowings is used for calculation of weighted average interest rate and is allocated to other qualifying assets that are not ready for intended use and that were not financed by special-purpose borrowings (or financing cannot be traced). In case when borrowings are refinanced the interest on new borrowings is also included in the calculation of the weighted average interest rate and then is allocated to the cost of qualifying assets.

The Company applies the above stated requirements of IAS 23, and considers the costs of the on-going construction of qualifying assets under the investment program as the reason for bearing the costs of borrowed funds; therefore such costs should be included in the cost of qualifying assets.

The basis for such conclusions is impossibility to determine that the source of funding of the new qualifying assets are borrowings received earlier, that could have been repaid if no financing of the new qualifying assets was made. If in the current reporting period the borrowings are refinanced, the construction of new qualifying assets is also can be the reason for that.

The opposite opinion is that during the allocation of borrowed funds for particular qualifying assets the borrowing costs may only be included in the cost of these particular assets. Therefore, when the qualifying assets are ready for intended use the borrowing costs of such borrowings shall be recognized as an expense and not included in the cost of the remaining qualifying assets.

We consider this issue is rather a problem of professional judgment and the Company may use the chosen method of interest capitalization.

We also found that in 2009 IFRIC issued an answer on related issue which is summarized in the following.

IAS 23 Borrowing Costs - Meaning of ‘general borrowings’.

- The IFRIC received a request for guidance on what borrowings comprise ‘general borrowings’ for purposes of capitalizing borrowing costs in accordance with IAS 23. IAS 23 paragraph 14 states that ‘To the extent that an entity borrows funds generally and uses them for the purpose of obtaining a qualifying asset; the entity shall determine the amount of borrowing costs eligible for capitalization by applying a capitalization rate to the expenditures on that asset. The capitalization rate shall be the weighted average of the borrowing costs applicable to the borrowings of the entity that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset.’(emphasis added) The request asked for guidance on the treatment of general borrowings used to purchase a specific asset other than a qualifying asset as defined in the standard.
- The IFRIC noted that because paragraph 14 refers only to qualifying assets, some conclude that borrowings related to specific assets other than qualifying assets cannot

be excluded from determining the capitalization rate for general borrowings. Others note the general principle in paragraph 10 that the borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying expenditure on the qualifying asset had not been made. The IFRIC noted that IAS 23 paragraph 11 states ‘the determination of the amount of borrowing costs that are directly attributable to the acquisition of a qualifying asset is difficult and the exercise of judgment is required.’

The IFRIC noted that the standard itself acknowledges that judgment will be required in its application. In addition, the IFRIC concluded that any guidance it could provide would be in the nature of application guidance rather than an interpretation. The IFRIC also noted that the Board will consider whether to add this issue to the annual improvements project. The IFRIC therefore [decided] not to add the issue to its agenda.